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INFO OCT-01 EA-11 ISO-00 SP-03 AID-20 EB-11 NSC-07 RSC-01

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PASS TREASURY/OASIA FOR WIDMAN

SUMMARY: IN ANSWER TO SPECIFIC TREASURY REQUEST, FOLLOWING IS FINATT'S CURRENT BEST ESTIMATES OF JAPANESE PRODUCTION, PRICE AND B/P PROSPECTS. TWO ALTERNATIVE FORECASTS ARE PRESENTED. FINATT BELIEVES SLOW GROWTH ASSUMPTION IS MORE LIKELY. ALTERNATIVE RAPID RECOVERY PROJECTION MORE CLOSELY RESEMBLES JERC JULY 1974 FORECAST. BALANCE OF PAYMENTS PROSPECTS PARTICULARLY CLOUDED AT THIS TIME. IMPORT VOLUME GROWTH LINKED TO INDUSTRIAL PRODUCTION CHANGE AND EXPORT PERFORMANCE TO OECD ECONOMIC OUTLOOK IN REST OF WORLD. DETAILED REPORT INCLUDING ASSUMPTIONS AND METHODOLOGY WILL FOLLOW. END SUMMARY.

1. OVERVIEW: AT MID-YEAR JAPAN'S RECESSION MAY HAVE ALREADY BOTTOMED OUT, ALTHOUGH SOME JAPANESE ANALYSTS AREN'T SO SURE. VERY RECENT FORECASTS PROJECT JFY 74 REAL GNP GROWTH AT LESS THAN 2 PERCENT BECAUSE CYCLICAL TROUGH GENERALLY PLACED IN THIRD QUARTER. THE SPEED OF PROSPECTIVE RECOVERY IS SUBJECT OF WIDE DIFFERENCES OF OPINION EVEN WITHIN GOJ. SOME FORESEE NATURAL DEMAND

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FORCES AS LEADING TO RESUMPTION OF HIGH GROWTH RATE IN

1975. OTHERS ANTICIPATE ONLY SLOW RECOVERY IF PRESENT TIGHT FISCAL MONETARY POLICIES REMAIN IN FORCE. CONTINUING UPWARD PRICE PRESSURE AND POSSIBILITY OF ANOTHER LARGE WAGE SETTLEMENT NEXT YEAR IS CITED BY SOME AS NEED FOR CONTINUATION OF CURRENT RESTRAINT POLICY. GOJ NOW IN INITIAL PROCESS OF FORMULATING NEXT YEAR'S BUDGET AND FUTURE ECONOMIC POLICY. IN VIEW OF UNCERTAINTY OF FUTURE GOJ ECONOMIC POLICIES, TWO DIFFERENT PATHS OF EXPANSION HAVE BEEN PROJECTED BY FINATT. ONE ALTERNATIVE OF SLOW RECOVERY WILL LEAVE EXCESS CAPACITY IN LATE 1975 ABOUT AS HIGH AS IN LATE 1974, CREATE LESS INFLATIONARY PRESSURES AND RESULT IN STRONGER B/P POSITION. THE OTHER PROJECTION ASSUMES LESS RESTRAINT AND MORE RAPID RECOVERY, WHICH WILL ENTAIL FASTER PRICE ADVANCE AND IS LIKELY TO LEAD TO B/P DETERIORATION IN 1975.

2. PROVISIONAL SECOND QUARTER REAL GNP FIGURES JUST RELEASED SHOW SMALL 0.6 PERCENT RISE COMPARED WITH FIRST QUARTER DROP OF 4.7 PERCENT (REVISED). ON OTHER HAND, REAL FINAL DOMESTIC DEMAND (I.E. GNP LESS INVENTORY CHANGE AND NET FOREIGN BALANCE) PROBABLY DROPPED ANOTHER 2.5 PERCENT AFTER FIRST QUARTER 8.3 PERCENT DECLINE. SOFTNESS OF DOMESTIC SPENDING APPARENTLY CONTINUED INTO THIRD QUARTER. PACE OF INVENTORY BUILDUP HAS NOT ABATED, AND IN SOME INDUSTRIES ACCUMULATION OF UNSOLD GOODS IS RESULTING IN PRODUCTION CUTBACKS. IN CERTAIN OTHER INDUSTRIES ORDER POSITION REPORTEDLY IMPROVING. FINATT CONSIDERS INDUSTRIAL PRODUCTION INDEX A MORE RELIABLE GUIDE FOR MEASUREMENT OF SHORT-TERM CHANGES IN VOLUME OF OUTPUT THAN DEFLATED GNP STATISTICS IN PERIOD OF RAPID INFLATION. HENCE FINATT FORECAST PRESENTED BELOW IS BASED ON PERCENTAGE CHANGE OF SEASONALLY ADJUSTED INDUSTRIAL PRODUCTION INDEX OF MINING AND MANUFACTURING (WHICH HISTORICALLY HAS AVERAGE RELATIONSHIP OF ABOUT 1.1 TO 1 WITH REAL GNP PERCENT CHANGE). PRELIMINARY JULY PRODUCTION INDEX UNCHANGED FROM REVISED JUNE FIGURE OF 127.3 SUGGESTING OUTPUT AT OR CLOSE TO CYCLICAL TROUGH.

3. DEMAND PROSPECTS: MOF STILL KEEPING TIGHT REIN ON GOVERNMENT SPENDING ALTHOUGH PROSPECTIVE LARGE SUPPLEMENTED OFFICIAL USE

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MENTAL BUDGET FOR HIGHER RICE PAYMENTS AND GOVERNMENT SALARY INCREASE CONSIDERED TO BE INFLATIONARY. MOF REPORTEDLY SEEKING TO HOLD DOWN SPENDING INCREASE IN JFY 75. CONSUMER ATTITUDES REMAIN CAUTIOUS, BUT SOME ANALYSTS CONSIDER PROSPECT OF INCREASED MONEY WAGES AS STIMULATIVE FACTOR. HOUSING AND COMMERCIAL BUILDING IS STILL HARD HIT BY RESTRAINT POLICIES. ON OTHER HAND, EQUIPMENT INVESTMENT OF MANUFACTURING SECTOR REMAINS

BUOYANT, UNLIKE PREVIOUS RECESSION PERIODS. SOME ANALYSTS VIEW THIS BUOYANCY AS REFLECTING INADEQUATE CAPACITY IN SOME INDUSTRIES AS WELL AS NEED TO MODERNIZE AND INSTALL ANTI-POLLUTION CONTROL EQUIPMENT. OTHERS CONSIDER THE STRONG INVESTMENT PLANS TO BE BASED ON THE PROSPECT FOR RAPID CYCLICAL RECOVERY AND FUTURE GROWTH WHICH MAY NOT MATERIALIZE IF A "SLOW GROWTH" POLICY IS HENCE FORTH ADOPTED. SOME GOJ OFFICIALS (INCLUDING FORMER MINFIN FUKUDA AND BOJ GOV SASAKI) ADVOCATE SLOWER AND STABLE GROWTH RATE FOR JAPAN OVER LONGER TERM TO PREVENT RECURRENCE OF INTERNAL AGGRAVATIONS (E.G. POLLUTION) AND EXTERNAL FRICTIONS (E.G. HEAVY RAW MATERIAL DEMAND AND LARGE EXPORT INCREASES TO PAY FOR IT). IF THE GOJ ADOPTS A SLOW GROWTH POLICY THEN PRESENT DEMAND RESTRAINT MEASURES WILL, IN ALL LIKELIHOOD, BE RETAINED FOR A CONSIDERABLE PERIOD AHEAD.

4. INFLATION REMAINS PROBLEM OF SERIOUS CONCERN. RECENT AND PROSPECTIVE HIKES IN UTILITIES RATES AND PRICE OF RICE ARE CONSIDERED NECESSARY EVEN THOUGH THEY WILL RAISE THE CPI. GOJ IS SEEKING WAYS TO ACHIEVE PRICE REDUCTIONS FOR PRODUCTS IN OVERSUPPLY BY ABOLISHING SOME PRICE CONTROLS, REMOVING PRODUCTS FROM RESALE PRICE MAINTENANCE, AND THE FAIR TRADE COMMISSION IS SEEKING TO PREVENT COLLUSION IN PRICE SETTING AND RESTRAINTS ON PRODUCTION. THE RATE OF PRICE ADVANCE HAS MODERATED IN RECENT MONTHS. IF THE PRESENT TREND CONTINUES, THE RATE OF INFLATION IN CY 75 COULD BE REDUCED TO AROUND 10 PERCENT FOR WPI AND 13 PERCENT FOR CPI (AGAINST PROSPECTIVE INCREASES IN CY 74 OF 32 AND 24 PERCENT, RESPECTIVELY). IF SLOWER INFLATION RATE IS ACHIEVED, OFFICIALS ARE HOPEFUL THAT NEXT YEAR'S WAGE DEMANDS CAN BE RESTRAINED TO PERHAPS NO MORE THAN 15 PERCENT. NEVERTHELESS, LIKELY PRODUCTIVITY LIMITED OFFICIAL USE

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ADVANCE UNDER SLOW CYCLICAL RECOVERY WILL BE INSUFFICIENT TO PREVENT CONTINUED INCREASES IN UNIT COSTS SO THAT CONSIDERABLE COST-PUSH PRESSURES WILL BE UNAVOIDABLE ACCORDING TO SENIOR EPA OFFICIAL.

5. RISKS OF CONTINUED RESTRAINT POLICY: POLICY OF SLOW ECONOMIC REVIVAL MAY RESTRAIN DEMAND GROWTH AND PRICE PRESSURES WHEREAS RAPID REVIVAL WOULD RESULT IN MORE RAPID PRODUCTIVITY ADVANCE AND LESS PRESSURE ON UNIT LABOR COSTS. OVERHANG OF LARGE INVENTORIES ARE CREATING SERIOUS FINANCING PROBLEM FOR MANY BUSINESSES. PRODUCTION CUTBACKS, INCLUDING SOME TEMPORARY LAYOFFS, ARE CREATING APPREHENSIONS ABOUT JOB SECURITY AND EMPLOYMENT OPPORTUNITIES. CONSIDERATION IS BEING GIVEN TO SELECTIVE GOJ FINANCIAL ASSISTANCE TO SMALL BUSINESSES

AND OTHER SEVERELY HIT INDUSTRIES. FUTURE CAPACITY REQUIREMENTS IN ELECTRIC POWER, PETROCHEMICALS AND STEEL MAY LEAD TO FURTHER SELECTIVE RELAXATION OF ADMINISTRATIVE CONTROLS OVER INVESTMENT, TO ENSURE THAT BOTTLENECKS ARE NOT ENCOUNTERED WHEN ECONOMIC ACTIVITY RECOVERS.

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IF RESTRAINT POLICY WERE ABANDONED, JAPAN FACES NOT ONLY INFLATIONARY RISK BUT ALSO POSSIBILITY THAT WITHIN A YEAR ECONOMY WOULD AGAIN BECOME "OVERHEATED" AND REQUIRE REIMPOSITION OF RESTRAINTS. THUS GOJ OFFICIALS PRESENTLY REVIEWING WHICH SET OF POLICIES HAVE GREATEST ADVANTAGES AND FEWEST RISKS. OUTCOME OF REVIEW UNLIKELY TO BE COMPLETED AND A "CONSENSUS" ARRIVED AT FOR SEVERAL WEEKS AT EARLIEST. PRESENT FINATT ASSESSMENT IS THAT GOJ WILL TAKE VERY CAUTIOUS ATTITUDE IN DISMANTLING MOST OF THE CURRENT RESTRAINT POLICIES BUT WILL YIELD SELECTIVELY TO PARTICULARLY STRONG BUSINESS PRESSURES FOR "RELIEF." THEREFORE, MOST LIKELY PROSPECT AT THIS TIME IS FOR A "SLOW GROWTH" PROFILE FOR ECONOMIC RECOVERY.

6. PROJECTIONS: FINATT PRESENTS TWO ALTERNATIVE PRO-

JECTIONS OF CYCLICAL REVIVAL AND THEIR IMPLICATION FOR JAPAN'S BALANCE OF PAYMENTS IN VIEW OF THE UNCERTAINTY AT THIS TIME REGARDING FUTURE GOJ DOMESTIC ECONOMIC POLICY. FOLLOWING ARE HIGHLIGHTS OF THESE PROJECTIONS TO BE FOLLOWED BY REPORT DETAILING ASSUMPTIONS AND LIMITED OFFICIAL USE

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METHODOLOGY.

(A) SLOW GROWTH PROJECTION: INDUSTRIAL PRODUCTION WILL NOT EXCEED PREVIOUS PEAK (IV 1973) UNTIL SECOND QUARTER 1975. THE RATE OF INCREASE IN PRODUCTION WOULD BE SOMEWHAT LESS THAN THE TREND GROWTH IN PRODUCTIVE CAPACITY, THEREFORE, UNUSED CAPACITY IN LATE 1975 WOULD BE AT LEAST AS LARGE AS AT THE END OF THIS YEAR. RATES OF INFLATION WILL MODERATE CONSIDERABLY UNDER THE PRESSURE OF EXCESS CAPACITY AND SLOW DEMAND GROWTH. DESPITE CONSIDERABLE UNCERTAINTIES IN FORECASTING, A TRADE SURPLUS IS PROJECTED FOR THE SECOND HALF OF THIS YEAR BUT THE CURRENT ACCOUNT WILL BE VIRTUALLY IN BALANCE. IN 1975 SUBSTANTIAL SURPLUSES ON TRADE AND CURRENT ACCOUNT ARE PROJECTED.

(B) RAPID RECOVERY PROJECTIONS: BEGINNING IN THE THIRD QUARTER OF 1974 DEMAND WILL EXPAND IN ALL SECTORS. BY YEAR-END INDUSTRIAL PRODUCTION WILL HAVE EXCEEDED THE PREVIOUS PEAK OF LAST YEAR AND THE ECONOMY WILL AGAIN BEGIN TO FACE SUPPLY CONSTRAINT. THIS IS ROUGHLY THE SAME PATH PROJECTED BY JERC (REPORTED IN TOKYO 10697). INFLATIONARY PRESSURES WILL DIMINISH BUT BE MORE SEVERE THAN UNDER THE SLOW GROWTH PROJECTION. IN THE LAST HALF OF 1974 A TRADE SURPLUS IS ALSO PROJECTED BUT THE CURRENT ACCOUNT WILL REMAIN IN DEFICIT EVEN IN CY 1975.

(C) BALANCE OF PAYMENTS PROJECTIONS: PROJECTIONS OF IMPORT VOLUME WERE DERIVED FROM INDUSTRIAL PRODUCTION FORECASTS. PRICE CHANGES FOR NON-OIL IMPORTS WERE ASSUMED TO BE SIMILAR TO WPI PROJECTION. IMPORT VALUES OF RAPID RECOVERY PROJECTION DO NOT DIFFER GREATLY FROM JERC FORECAST. IN VIEW OF JAPAN'S STRONG EXPORT PERFORMANCE IN PAST TWO QUARTERS, BOTH IN VOLUME AND VALUE, DESPITE ECONOMIC SLOWDOWN IN MAJOR INDUSTRIAL MARKETS, FINATT ASSUMES THAT THIS WILL CONTINUE DURING CURRENT PERIOD OF INVENTORY OVERHANG AND SLACK PRODUCTION IN JAPAN. WORLD DEMAND REMAINS STRONG FOR CERTAIN PRODUCTS JAPAN CAN NOW SUPPLY TO EXPORT MARKETS, E.G. STEEL AND CHEMICALS. IN CY 75 PACE OF EXPORT ADVANCE IS EXPECTED TO SLOW SOMEWHAT. FINATT EXPORT PROJECTION LIMITED OFFICIAL USE

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MORE OPTIMISTIC THAN JERC. DEFICIT ON INVISIBLES AND TRANSFERS HAS GROWN RAPIDLY OVER PAST YEAR REACHING \$3 BIL IN FIRST HALF 74, AND GROWTH IS EXPECTED TO CONTINUE. FOR CY 75 INVISIBLES DEFICIT PROJECTED TO REACH \$7 BIL WHICH IS SUBSTANTIALLY HIGHER THAN JAPANESE PROJECTIONS FOR SAME PERIOD RANGING BETWEEN ONLY \$5.2-5.7 BIL.

(1) SUMMARY OF PROJECTIONS
ANNUAL PERCENT CHANGES

DOMESTIC ECONOMY: (A) SLOW GROWTH (B) RAPID RECOV.

IND. PROD. (MINING, MANUF)

1974 2ND HALF/1ST HALF#	MINUS 2.4	2.5
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CY 1974	0.5	1.8
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CY 1975	4.9	9.3
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IV 75/IV 74	6.9	9.6
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WPI

1974 2ND HALF/1ST HALF#	12.1	14.0
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CY 1974	31.9	32.5
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CY 1975	10.3	14.1
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IV 75/IV 74	9.1	13.6
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CPI

1974 2ND HALF/1ST HALF#	14.2	18.7
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CY 1974	23.6	24.9
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CY 1975	12.7	15.7
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IV 75/IV 74	11.6	13.2
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PERCENTAGES AT ANNUAL RATES

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2) BALANCE PAYMENTS
(IN BILLIONS OF DOLLARS)

	1974				
A. SLOW GROWTH	I-II SA	III-IV SA	CY74	CY 75	
EXPORTS	25.0	30.0	55.0	70.7	
IMPORTS	26.2	26.7	52.9	58.9	
TRADE BALANCE	-1.2	3.3	2.1	11.8	
SERV. & TRANSFERS	-3.0	-3.4	-6.4	-7.0	
CURRENT ACCOUNT	-4.2	-0.1	-4.3	4.8	
B. RAPID RECOVERY					
EXPORTS	25.0	30.0	55.0	70.7	
IMPORTS	26.2	27.4	53.6	64.1	
TRADE BALANCE	-1.2	2.6	1.4	6.6	
SERV. & TRANSFERS	-3.0	-3.4	-6.4	-7.0	
CURRENT ACCOUNT	-4.2	-0.8	-5.0	-0.4	

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